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TAGS: [ECON](#) [ETRD](#) [EFIN](#) [EINV](#) [POL](#) [PREL](#) [UP](#)  
SUBJECT: UKRAINE: YANUKOVYCH ECONOMIC POLICY RECORD MIXED

REF: A. KIEV 3755  
[B. KIEV 3670](#)  
[C. KIEV 3783](#)  
[D. KIEV 3905](#)

Classified By: Ambassador for reasons 1.4 (b) and (d)

[1](#)1. (C) Summary: After eight weeks in power, the Yanukovych government's record on economic policy in a number of areas has not been as bad as some expected, nor as good as others hoped. The conventional wisdom among the foreign business community has swung from "let's give them a chance" to "deja vu all over again." Apparently forgetting their frustration with the Tymoshenko and Yanukovych government's failure to enact their reformist agendas, many businessmen point out that the Yanukovych agenda seems to lack economic reform altogether. Separating alarmism from real GOU policy moves presents a more nuanced picture. Some of the moves taken to date have been negative: the freezing of VAT refunds, the GOU's embrace of RosUkrEnergo, and the imposition of restrictions on grain exports. At least one move seems clearly positive: maintaining the policy that Ukraine would not sacrifice EU aspirations for integration with the Single Economic Space. In most other areas -- including WTO accession, the reactivation of special economic zones, and the budget -- the GOU's rhetoric and policy steps have so far been ambiguous and its intentions are still indecipherable. The record to date is therefore mixed, but trending negative. We will be watching policy moves in key areas to see if that trend continues. End Summary.

GRAY EXPECTATIONS

[1](#)2. (C) The return of Viktor Yanukovych as Prime Minister was bemoaned by some as a betrayal of the Orange Revolution, and welcomed by others as a chance for effective government after a period of disappointing inaction. Although the Party of Regions has prominent members who represent powerful industrial interests associated with Kuchmaism, many observers hoped the oligarchs would steer the party toward enlightened pro-market and pro-Western policies rather than reverting to the cronyism and kleptocracy of the past. The USG has adopted a pragmatic approach, judging the government on the actions it takes.

[1](#)3. (C) Hopes that the new Yanukovych government marked a significant break with the past were dampened by Mykola Azarov's appointment as First Deputy Prime Minister and Minister of Finance, the dual role he had occupied under Yanukovych and President Kuchma. Certainly Azarov is

widely-acknowledged to be decisive, intelligent, and to have real managerial talent. If this energy is harnessed to serve reformist goals, then it would be a welcome change from the policy paralysis of the previous two governments. Azarov, however, was also renowned for his willingness to use administrative power against the regime's enemies or to enrich the well-connected. As Head of the State Tax Administration (STA) from 1997 to 2002, his tax police were much feared and the system of authorizing VAT refunds notoriously corrupt. As a recent article in "Delovaya Stolitsa" put it, Azarov represents the old Donetsk clan of veteran Soviet nomenclatura, rather than the new Donetsk clan of rich businessmen.

#### VANISHING VAT REFUNDS

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Scorecard: Negative

14. (C) At the top of the "negative" column is the freezing of VAT refunds to exports. As one of Azarov's first moves, this seemed to confirm that he was bringing back the old system of extensive administrative control. In his second week in office, he instructed the STA to suspend the repayment of VAT refunds to exporting businesses. Press reports in early September claimed that the only VAT refunds the STA had paid in August went to Donetsk firms. Rumors held that the Donetsk firms in question all belonged to Party of Regions sponsor Rinat Akhmetov. In response to these reports, President Yushchenko ordered the Prosecutor General to investigate August VAT repayments. Discussions with U.S. investors, including non-agricultural firms, confirmed VAT arrears have soared. However, some non-Donetsk firms (e.g., Mittal Steel Kryvyi Rih) say they have had no problem with VAT refunds. (Note: Azarov has on three occasions -- most recently on September 26 -- promised Ambassador or Deputy Chief of Mission that he would make sure U.S. agricultural processing and trading companies received their refunds, which now approach \$100 million. Azarov's office called the Embassy this week and requested additional information on these businesses. One of the business received a small partial refund on October 3. End Note.)

15. (C) State Tax Administration officials attribute any delays in VAT refunds to the necessity of carrying out crosschecks of the entire supply chain of exporters before authorizing a refund. Since even local tax offices themselves have admitted to businesses that they are unable to carry out such crosschecks, the policy amounts to a de facto freeze on most refunds.

#### BUDGET POLICY

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Scorecard: Ambiguous

16. (C) Azarov's proposed 2007 budget falls into the "too early to tell" category. While engaging in the typical politician's ploy of blaming his predecessors for the mess they left him, Yanukovych in actuality has been fortunate in inheriting a rather healthy economy and fiscal situation. Some of Finance Minister Azarov's budget proposals, e.g. curbing the growth of social spending and addressing pension reform, seem sensible. Critics point out, however, that the cuts in some forms of social spending are more than offset by proposed rises in others. They also criticize the proposed creation of a three billion hryvnia stabilization fund to be used at the discretion of the Cabinet of Ministers, and the emphasis on state-directed investment. While the draft 2007 budget's deficit (now planned for 2.55% of GDP) is not excessive, there are worrisome signs. The GOU has embarked on renewed borrowing. Promises of tax reduction for business, combined with privatization receipts that are likely to be even smaller than planned in the budget, point to a danger of a growing budget deficit. Keeping the fiscal deficit low and adequately financed was one of the successes of the post-Orange Revolution governments - the new government seems to have abandoned this hard line.

## BETTER SPECIAL ECONOMIC ZONES?

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Scorecard: Ambiguous

¶17. (C) It is also premature to judge Azarov's efforts to reactivate the special economic zones (SEZs). The GOU's current proposal appears to be an improvement over the system that was in place prior to April 1, 2005, when Tymoshenko's budget ended the regime of tax and customs privileges offered businesses in the SEZs. Although some companies operated legitimately within them, the SEZs had been notoriously corrupt. Shell firms could reap huge profits by channeling flows of funds through the zones to avoiding taxes; importers used the zones as a customs-free channel for goods to enter the Ukrainian market, making the zones WTO inconsistent. Tymoshenko's cancellation of these privileges, although criticized for being abrupt and for penalizing legitimate investment within the zones, was generally welcomed as a blow against corruption and for sound fiscal policy.

¶18. (SBU) The GOU's draft legislation, released on September 22, seems designed to avoid some problems of the past. Consideration of the draft legislation is reportedly far off, and the text, in any case, is subject to possible changes in the Rada. As it stands, the draft vests authority in the Ministry of Economy, rather than with local officials, for approving projects for privileged tax treatment. By centralizing the power to decide who gets the tax and customs privileges, Azarov may be reducing opportunities for local level corruption, but is gathering still more power into a Cabinet of Ministers that he dominates.

¶19. (SBU) To aid new investment projects it provides customs duties exemptions for goods used to construct investment projects, and a three-year corporate income tax holiday for new investment projects. For export processors, it provides facilitation of VAT and customs payments on non-agricultural goods temporarily imported and sets out general rules for applying customs and VAT to goods leaving the zones and entering Ukraine's Customs territory. (Note: Without more details on these rules and, perhaps, a track record of implementation, it is difficult to say whether the proposed SEZ regime would be WTO consistent.)

¶10. (C). Although designed to address Ukraine's real need to compete with neighboring countries for FDI dollars, and to facilitate export processing, the reactivation of the SEZs, even if they function ideally, remains a controversial approach. Many observers suggest that Ukraine would be better off concentrating on creating favorable conditions for investment and easing customs processing procedures for businesses throughout the country, rather than granting privileges to firms in special zones. (Comment: Given their checkered record in Ukraine, post remains skeptical that SEZs will be implemented in a transparent and corruption-free manner.)

## MIXED SIGNALS ON WTO

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Scorecard: Ambiguous

¶11. (SBU) Though WTO accession is nominally at the top of its priority list, the GOU has sent conflicting signals about its actual intentions. Rhetorically, the GOU has backed the potentially incompatible goals of protecting domestic producers and acceding to the WTO in 2006 (Ref B). Both Yanukovych and Azarov have flirted with the idea of seeking a rollback in some of Ukraine's commitments made to date in WTO negotiations in order to protect domestic producers. Azarov has suggested that many of the tariffs that the Tymoshenko government lowered should be restored to higher rates. He advocates import substitution and export promotion to spur growth, policies that are difficult to achieve without WTO-inconsistent measures.

¶12. (SBU) In actual practice, the GOU has taken two worrisome steps: it has delayed consideration of WTO legislation and, in a September 28 Cabinet of Ministers' decree, instituted

export licensing on wheat in an effort to keep prices low for millers. The delay has come from Yanukovych's insistence on giving businesses and Rada members a chance to review the benefits of WTO membership in general, and the accession terms specifically. The grain trade restrictions seem likely to seriously complicate WTO accession.

#### STANDING FIRM ON SINGLE ECONOMIC SPACE

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Scorecard: Positive

¶13. (SBU) Yanukovych's position on economic integration within the Single Economic Space (with Belarus, Kazakhstan, and Russia) has so far not differed from that expressed by previous governments dating back to Kuchma. He has held to the line that Ukraine is interested primarily in the SES becoming a free trade area, but not a customs union. Joining an SES customs union would complicate WTO accession and be inconsistent with aspirations for a free trade agreement with the EU. Yanukovych backs close economic ties with Russia more vociferously than his predecessors, but he has not yet closed any doors to Ukraine's increasing its economic integration with the EU.

CONCLUSION: POSITIVE

#### WHAT'S THE REAL PRICE OF CHEAP RUSSIAN GAS?

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Scorecard: Worrisome

¶14. (C) Perhaps the most important question about GOU policy that still remains unanswered is how far Ukraine will go to get favorable energy terms from Russia. With the appointment of former NaftoHaz CEO Yuriy Boyko, a figure who was involved in the founding of RosUkrEnergo (RUE), as Minister of Fuels and Energy, the new GOU rejected decisively the efforts of some previous government officials to undermine or revise the basic arrangements of the January 4 gas agreement. Instead, the GOU has cemented the central role of shady middleman RUE, half of which is owned by Gazprom. It has also benignly encouraged the expansion of the activities of UkrHazEnergo, a joint venture between NaftoHaz and RUE created by the January 4 deal to handle the sale of imported gas within Ukraine. Despite efforts in early 2006 by the GOU to limit UkrHazEnergo's role in the market, the joint venture has succeeded in taking over much of NaftoHaz's business of selling gas to industrial consumers, and has begun efforts to expand into other aspects of energy distribution. While this process began under the previous government, the new GOU has given UkrHazEnergo a freer rein in roaming into new areas (such as production and distribution). This is distressing to those who see the joint venture as a Trojan horse for GazProm.

¶15. (C) In order to obtain adequate natural gas supplies and an optimal price from Russia, Ukraine has been discussing broad "strategic cooperation" with Russia. So far the contours of Ukraine-Russia "strategic cooperation" are not clear, pending the results of the November Yushchenko-Putin Interstate Commission and 2007 gas price negotiations. Both GOU and Russian officials have hinted at linkages to electricity exports, nuclear power station construction, as well as openness to joint ventures in the energy sector itself. For example, Ukraine may indirectly participate in joint oil and gas production projects on Russian territory.

¶16. (C) A central concern is whether strategic cooperation will result in some ceding of control over key assets of Ukraine's economy to Russian entities including Gazprom. Encouragingly, the new GOU has said Ukraine's gas pipeline system remains off-limits to Russian control via a vehicle like the International Gas Consortium, but Minister Boyko has shown willingness to allow Russian firms to acquire Ukrainian regional gas distribution companies. Talks are currently underway for sale of as many as eight of these companies either to RUE or to UkrHazEnergo. Russian oligarch Viktor Vekselberg reportedly bought four other regional distribution companies in July.

## STATE INVOLVEMENT IN GAS AND OIL DEVELOPMENT

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Scorecard: Worrisome

¶17. (C) The new GOU's approach to natural gas and oil exploration and development in the Black Sea as well as onshore suggests hostility to foreign productive investment. In contrast to the previous GOU's efforts to attract foreign investment and technological expertise, Minister Boyko announced that future exploration and development task should be left to Ukrainian state-owned firms, perhaps with foreign financing. (Comment: NaftoHaz's abysmal reputation as a borrower and their lack of know-how makes this strategy dubious, to say the least.)

¶18. (C) Boyko's statement seemed to threaten the production sharing concession that Houston firm Vanco had already won in April 2006 for a block in the Black Sea off Crimea. When Minister of Environment Dzharty then announced that Vanco was in procedural violation of its terms and could lose the contract, it reflected what was rumored to be a widespread GOU view that the deal should be scuttled. While in meetings with GOU officials Vanco officials said they made some progress in September, it appears that some GOU officials' opposition to Vanco came from a combination of ignorance of the terms of the deal and grumbling by losing bidders. Boyko told the Ambassador October 4 the GOU is committed to finish the negotiations with Vanco (Ref C). Prime Minister Yanukovych the same day reiterated that view to Deputy Assistant Secretary David Kramer (Ref D). (Comment: However, neither Vanco nor post believes they are out of the woods yet.)

## PRIVATIZATION: NOT A PRIORITY

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Scorecard: Negative

¶19. (SBU) Serious privatization of state enterprises seems to be at a standstill, and there apparently is an indefinite suspension of plans to sell Ukrtelecom, local energy companies, or port facilities. The Tymoshenko government took the first tentative steps on these privatizations, but never moved to completion. Azarov's government has not yet turned to them. Methods of privatization are becoming less transparent, with open tenders replaced by insider awards. For example, a planned tender for a Luhansk locomotive plant was cancelled and instead the government plans to sell to a hand-picked buyer.

## WHAT'S MISSING: LIBERAL ECONOMIC REFORMS

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Scorecard: Ambiguous

¶20. (C) In recent meetings with members of the American Chamber of Commerce, foreigners doing business in Ukraine expressed their suspicions of Azarov. All agreed he was now the undisputed tsar of economic policy, especially as non-political diplomat Volodomyr Makukha appears to have little policy clout as Minister of Economy. To many businessmen's ears, Azarov is sounding like an old-school dirigiste manager, announcing a five-year plan for Ukraine's re-industrialization that is dependent on state selection of priority sectors and budget-supported investment. His moves on VAT refunds and the SEZs are seen as consolidating his power, which, businessmen tell us, they expect he will use to favor those politically connected to the regime.

¶21. (SBU) Many businessmen complain that the GOU's impact on the business climate will come as much from what it does as from what it has no apparent intention of doing. Missing from the Yanukovych/Azarov set of economic policy priorities is the agenda of reforms businessmen and international observers have been advocating to no avail for several years, including under the Tymoshenko and Yekhanurov governments. These include judicial reform, deregulation, passage of a joint stock company law, abolition of the commercial code, and ending the moratorium on sale of agricultural land.

COMMENT

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¶22. (C) There is no question that many of the policies pursued by the Yanukovych government are not what western businessmen and economists consistently prescribe. Nonetheless, it is important to remember that the record of the Tymoshenko and Yekhanurov governments on economic reform was thin, despite their greater rhetorical support for the reformist agenda. The record so far of the Yanukovych GOU's actual policy steps is mixed, but trending negative. We will be watching developments in all the key areas cited above to see if the GOU can polish its rapidly tarnishing image on economic policy.  
Taylor